Chapter 4

A MODEL CASH FLOW TAX

INTRODUCTION

This chapter presents a proposal for a consumption base tax as an alternative to a comprehensive income tax. Called a "cash flow" tax because of the simple accounting system used, this tax is designed to replace the current taxes on the income of households, individuals, trusts, and corporations.

The major difference between the cash flow tax and the comprehensive income tax outlined in chapter 3 is that the change in an individual's net worth is effectively excluded from the base of the cash flow tax. In many other respects, the two taxes are alike. Consumption is included in both tax bases. The measure of consumption in the cash flow proposal is broadly similar to that in the comprehensive income tax proposal; it differs mainly in that it includes the flow of consumption from consumer durables and owner-occupied housing and certain other forms of in-kind consumption. The treatment of the family unit for tax purposes is the same in both the comprehensive income and cash flow proposals.

The concern of this chapter is to define the appropriate base of the cash flow tax system. The issue of the progressivity of the tax system is a separate problem that would have to be resolved for either the cash flow tax or the comprehensive income tax. This issue is considered for both taxes in chapter 5.

Cash Flow Accounting

The central feature of the model tax system is the use of cash flow accounting for financial transactions to obtain a measure of annual consumption for any individual or household. The principle involved is very simple. A household could use monetary receipts in a year for three purposes: personal consumption, saving, and gifts. By including all monetary receipts in the tax base, including the entire proceeds of sales of assets and gifts received, and allowing deductions for purchases of assets and gifts given, the annual consumption of a household could be measured without directly monitoring the purchases of goods and services.

The use of cash flow accounting of financial asset transactions to compute the tax base is illustrated, for an average wage earner, in the following example. Suppose a worker earns \$10,000 per year in wages, of which he uses \$9,000 for personal consumption and \$1,000 for saving. Under the cash flow tax outlined in this proposal, the worker could deduct \$1,000 from his \$10,000 of wages, if he had deposited the \$1,000 in a qualified account.

Use of Qualified Accounts. Qualified accounts would be established by banks and other financial institutions, which would keep records of deposits and withdrawals. The worker's \$1,000 deposit in the account could be used to purchase any type of financial asset -- savings bank deposits, corporate shares, bonds, mutual funds, or any other claim to current or future income. The future balance in the qualified account would depend, of course, on the profitability of his investments. No tax would be assessed against interest, dividends, or capital gains as they are earned, but the taxpayer would be required to include in his tax base the full value of any withdrawals from his qualified account that were not reinvested in similar accounts. The use of qualified accounts to handle financial transactions would ease the taxpayer's recordkeeping burden and would enable tax authorities to trace the annual flow of funds available for consumption uses.

The qualified accounts described here are very similar to qualified retirement accounts under current law. These accounts include Keogh plans and Individual Retirement Accounts (IRA's), which provide the taxpayer a current deduction for contributions to funds for retirement and, then, include withdrawals from the fund in the tax base after retirement. There are two major differences between the qualified accounts proposed here and qualified retirement accounts provided for in the current tax code. First, withdrawal of funds from the qualified account would be allowed without penalty at any time during a taxpayer's lifetime. Second, there would be no statutory limit to the amount a taxpayer could contribute to a qualified account.

Thus, in the example above, if the worker deposited \$1,000 in a savings account, his tax would be computed on an annual cash flow base of \$9,000. If, in the following year, he consumed his entire salary of \$10,000 and in addition withdrew \$500 from his savings account to purchase a color television set, his cash flow tax base in that year would be \$10,500. His tax base is geared to the use of his receipts for consumption, currently or in the future.

Alternative Treatment of Investments. An alternative way of handling investments that would enable an individual to alter the timing but not the expected present value of his cash flow tax base would be to include the purchases of assets in the tax base, but to exempt all returns from assets from tax. To continue the example above, the worker could deposit $1,000 of his $10,000 of annual wages in a savings bank, but without using a qualified account. If he did so, the entire $10,000 of wage receipts would be included in his tax base in the initial year, but any future interest earned on the savings deposit and any withdrawal of the principal would be excluded from the tax base. As will be discussed more fully below, the expected present value of the worker's lifetime tax base would be the same for either method of accounting, if he consumes the proceeds of his account during his lifetime.

Investments handled in this alternative way would be treated very simply for tax purposes. The amount invested would be included in the tax base -- the same as consumption -- but all subsequent returns on the investment would be untaxed. In effect, the tax that would otherwise be due on consumption from the proceeds of the investment would be prepaid at the time the investment is made. Allowing taxpayers the choice of this alternative way of handling investment accounts has some advantages, but could create problems, which are discussed below.

The possibility is discussed of dealing with these problems by introducing restrictions on the types of investments that may or must be made through qualified accounts. Although few restrictions are recommended in the model plan, it should be stressed that to increase their number or stringency would be fully consistent with the basic concept of the cash flow tax and would not alter its most important features.

The remainder of this chapter presents the details of a model cash flow tax base and discusses its most important characteristics. The next section points out the tax issues that have common solutions in the model comprehensive income tax and the model cash flow tax. Then, a section is devoted to the major differences between the two tax bases, including a full description of the cash flow tax treatment of investment assets and consumer durables. Another section discusses the economic consequences of adopting a cash flow tax, and the final section presents a sample tax calculation form.

ELEMENTS IN COMMON WITH THE COMPREHENSIVE INCOME TAX

Several of the issues discussed in the preceding chapter would be resolved similarly for a cash flow tax. These questions include the measurement of consumption -- to be taxed alike in both models -- and the related issue of the appropriate treatment of families of varying size and circumstances.

Family Size and Family Status

Under this proposal, the family would be taxed as a unit for reasons analogous to those argued in chapter 3. In order to assess tax to each family member as an individual, it would be necessary to allocate consumption among family members. This would destroy much of the administrative simplicity of the cash flow tax, which rests upon deducting from receipts certain cash outlays that are usually made on behalf of the family as a unit. Receipts are also usually combined at the family level. The argument that standard of living varies by family size holds for a consumption measure of living standard as well as for an income standard. The adjustment device in the model cash flow tax plan discussed in this chapter -- one exemption per family member -- is the same as that proposed for the comprehensive income tax. However, differences in the size of the tax base under the two taxes might require that the exemption levels be different for model taxes intended to raise the same revenue. As in the case of the comprehensive income tax, other approaches to the adjustment for family size would be fully consistent with the cash flow tax base.

Adjustments that account for differences among families in the number of wage earners and the availability of a full-time adult in the household apply to labor-related earnings and expenses only. They would be just as appropriate, therefore, under a consumption tax as under an income tax. The structure of rates required to achieve the desired pattern of progressivity might be different, however.

Deductions for Charitable Contributions, Medical Expenses, and Taxes

Contributions to Charities. As in the case of the comprehensive income tax base, deductions for charitable contributions would not be allowed under the model cash flow tax. Conceptually, under a cash flow tax, itemized gifts should be deductible by the donor and included in the receipts of the donee. Following the discussion in chapter 3, including receipts from charities in the tax base of the recipient is rejected as impractical. Charity is not usually given in cash or in goods that are easy to value, and sometimes the benefit is to society generally, so that beneficiaries cannot be separately identified. Nor should the charitable institutions be taxed. They do not consume; they merely act as intermediaries to distribute the benefits to the ultimate recipients. The foregoing suggests that the best way to tax consumption resulting from charitable activities would be to count charitable contributions as consumption by the donor and not to allow a tax deduction.

In opposition to this proposal, it may be argued that tax-free consumption of goods and services provided by charities should be maintained because these goods and services provide a public service function. Proponents of this view would argue for either a deduction or some form of tax credit for charitable contributions. As noted in chapter 3, however, the decision whether or not to allow the deduction of charitable contributions is not essential to the basic integrity of the overall proposal.

There is one element of the comprehensive income tax discussion of charities that does not apply to a cash flow tax. The undistributed portion of endowment earnings of charitable organizations should not be taxed even if taxation of organizations on the basis of contributions is viewed as feasible and recommended as a general policy.

Medical Expenses. The issues involving medical expenses and medical insurance are exactly the same for the cash flow tax as for the income tax. Consequently, the same policy options are prescribed for both model taxes.

State and Local Income Taxes. The model cash flow tax treatment of State and local taxes also would be the same as that under the model accretion tax: income taxes would be fully deductible because they are not regarded as part of consumption. Other taxes would not be deductible, except as business expenses.

Property Taxes. No property tax deduction would be allowed to homeowners under either of the model taxes. The rationale for denying deduction of the property tax for owner-occupied homes is, however, somewhat different in the case of the cash flow tax. The cash flow tax would measure the owner's consumption of housing services as the purchase price (or capital value) of the dwelling. In a market equilibrium, this price is the present value of the prospective stream of imputed rents less current costs. These costs include property taxes. Therefore, a higher local property tax, if uncompensated by services to the property, would result in a lower market price of the dwelling. In this way, the property tax is excluded from the base of the cash flow tax without an explicit deduction.

Health, Disability, and Unemployment Insurance

Those types of insurance that are purchased for a 1-year term and pay benefits directly to the insured -- health, disability, and unemployment insurance -- are no different in concept or model tax treatment under the cash flow tax than under the accretion tax. They are included in the definition of consumption. The differences in treatment among them -- taxation of benefits in the case of disability and unemployment, and of premiums for health insurance -- are explained in the preceding chapter. The model tax treatment is the same for each of these items whether the insurance is public or private, employer-paid or employee-paid. However, life, casualty, and old-age insurance do present differences in concept under the consumption tax and will be discussed below.

Casualty Losses

Casualty losses would not be deductible under the model comprehensive income tax or under the cash flow tax. Again, however, the rationale for not allowing the deduction under the cash flow tax is slightly different. Under the cash flow tax, changes in net worth would not be included in the tax base, and, therefore, reductions in net worth, in general, should not be deducted. Further, as explained below, all taxation for the consumption of consumer durables would be prepaid at the time of purchase, and subsequent sales of consumer durables, at whatever price, would not be included in the tax base. Following the same reasoning, the premiums for casualty insurance would not be deductible under the cash flow tax proposal, and the proceeds would be excluded from the tax base.

DIFFERENCES BETWEEN THE CASH FLOW TAX AND THE COMPREHENSIVE INCOME TAX

The major difference between the cash flow tax outlined here and the comprehensive income tax presented in chapter 3 follows directly from the definition of the two bases. Under the cash flow system, changes in net worth would not be included in the tax base, but the comprehensive income tax would attempt to include all changes in net worth to the extent administratively feasible. Thus, the cash flow tax and the income tax differ in their treatment of purchases of assets and returns from asset ownership. Specifically, the two taxes differ most in the handling of corporate profits, income from unincorporated business, capital gains, interest received on savings and interest paid on loans, rental income, income accrued in retirement plans and life insurance, and casualty losses.

The first part of this section discusses in some detail the treatment of investment assets and consumer durables under the cash flow tax proposal. In the second part, a comparison is made between specific provisions of the model comprehensive income tax and the handling of corresponding items under the model cash flow tax.

The Treatment of Assets Under a Cash Flow Tax

The cash flow tax would greatly simplify tax accounting and tax administration regarding real and financial assets. Accounts to determine capital gains, depreciation, and inventories -- among the most complex necessitated by the current tax code -- would no longer be required. For many individuals, no accounting would be necessary for asset purchases nor for receipts associated with asset ownership. For other taxpayers, simple annual cash flow data would provide all the necessary information for computing tax liability. The taxpayer would merely record the net annual deposits or withdrawals from qualified accounts. Accounting for the cash flow tax would rest solely on marketplace transactions for the current year, thus minimizing the need for long-term recordkeeping.

Family-Owned Businesses. The simplicity of cash flow tax accounting is best illustrated by the model tax treatment of a family-owned business. All cash in-flows would be counted as receipts. Cash outlays that represent business expenses -- including all purchases of equipment, structures, and inventories -- would be deducted from receipts; that is, instantaneous depreciation for tax purposes would be allowed on all investments regardless of the durability of the asset purchased. The difference between receipts and cash outlays would be included in the individual's tax base. If cash outlays exceed business receipts in any year, the difference would reduce receipts from other sources.

For example, suppose a family derived all its receipts from a family-owned grocery store. To compute its tax base, the family would add up all cash receipts from sales and subtract from this amount all business outlays, including payments to employees and cash outlays for electricity, rent payments for the store, purchases of machinery, and purchases of inventories. These would be the only calculations the family would make to determine its tax base under the cash flow tax. No data on capital gains or depreciation would be required to determine taxable receipts.

Financial Assets. Financial assets, including stocks, bonds, and savings deposits, owned by taxpayers via qualified accounts would be recorded for tax purposes in the same way as annual purchases and sales associated with a family-owned business. All deposits for purchases of assets would be deducted from other receipts in computing the tax base. All withdrawals, whether arising from dividends, interest, or asset sales, would be included in the tax base. No distinction would have to be made between the gain from sale of an asset and the return of capital invested.

For example, suppose an individual deposits $100 in a qualified savings bank account, where it earns 10 percent annual interest. In the year he makes the $100 deposit, he would be allowed to deduct $100 from current receipts in computing his tax base. If, in the following year, he withdraws the principal plus earned interest -- now equal to $110 -- the amount withdrawn would be added to receipts from other sources in computing the tax base. If, instead, the savings deposit were left in the bank to accumulate interest, there would be no current tax consequences. Any future withdrawal would add to taxable receipts in the year it is made.

Deductions for the purchase of assets would be allowed only if the purchase were made through a qualified account. This device would offer a simple way to insure compliance with the cash flow tax. Individuals would be permitted to keep qualified accounts with savings banks, corporations, stockbrokers, and many other types of financial institutions. The net amount of deposits in, and withdrawals from, qualified accounts during the year would be reported by the institution to both the taxpayer and tax authorities. The present dividend-reporting requirements for corporations may be viewed as a model for the way financial institutions would report net withdrawals and deposits from qualified accounts for the cash flow tax.

The tax base of an individual would include the sum of net withdrawals from all qualified accounts. If deposits exceeded withdrawals, the excess would be subtracted from other receipts in computing the tax base. The sale of one asset out of a qualified account and subsequent purchase in the same year of another asset of equal dollar value would have no net tax consequences if the new asset were also purchased in a qualified account.

Consumer Durables. It is technically feasible, but practically unattractive, to apply the cash flow concepts just described to the purchase of consumer durables. Unlike financial assets, consumer durables such as automobiles, houses, and major home appliances, all yield flows of services to the owners that are not measured by annual monetary payments. Thus, to allow a deduction for consumer durable purchases and then to include only future monetary receipts in the tax base would amount to excluding from the tax base the value of consumption services yielded by durable goods. Because it is difficult to determine the annual value of the use of consumer durables the same concepts used for financial assets cannot be easily applied.

For example, suppose an individual purchased an automobile for $4,000 and sold it for $2,000 3 years later. If a deduction were allowed for the purchase and, then, the sale value included in receipts, the individual's total tax liability would be lowered by owning the automobile. However, the individual would have expended $2,000 plus some foregone interest for the consumption services of the automobile over the 3-year period. The depreciation and foregone interest measure the cost of the consumption services and should be included in the tax base. If the automobile were taxed the same way as an asset in a qualified account, this consumption value would escape the tax.

To assure that the entire consumption value is included in the tax base, the appropriate treatment of consumer durables is to allow no deduction on purchase and to exclude sales receipts from the tax base. In other words, purchase of a consumer durable would be treated the same way as current consumption of goods and services. The reason for this approach is that the price paid for a consumer durable should reflect the present value of future services the buyer expects to receive. Including the value of durable goods in the tax base at the time of purchase produces, in effect, a prepayment of the tax on the value of future consumption services.

According to this treatment, the $4,000 for the purchase of the automobile would not be deducted from the tax base. Similarly, the $2,000 from sales of the automobile 3 years later would not be included in the tax base. Thus, if an individual sold a used car and bought another used car for the same price, or used the proceeds for current consumption, there would be no tax consequences. If he sold a used car for $2,000 and invested the proceeds in a qualified asset, he would deduct $2,000 from his tax base in the year of the transaction.

In summary, the purchase of a durable good would be treated as present consumption even though the good yields consumption services over time. The reason for this approach is that the price of the good reflects the expected present value of its future stream of services. Measuring annual service flows directly would require the measurement of annual depreciation and annual imputed rent on the value of the asset. This would introduce unwanted and unnecessary complexity into the cash flow tax system.

<u>Checking Accounts</u>. Deductions should also be derived for purchases of certain types of financial assets that yield their primary benefits in the form of services received, rather than monetary returns. For example, non-interest-bearing demand deposits provide services for depositors in place of interest. Deductions, therefore, should <u>not</u> be allowed for deposits in checking accounts, and withdrawals from checking accounts should <u>not</u> be included in the tax base. That is, checking accounts should not be qualified accounts.

Equivalence of Qualified Account Treatment and Tax Prepayment Approach

The equivalence noted above between the purchase price of a consumer durable good and the present value of its expected future services suggests an analogous equivalence between the price of a business or financial asset and the present value of its expected future stream of returns. This equivalence can best be illustrated by a simple example. Suppose an individual deposits \$100 in a savings account at 10 percent interest in year 1. In year 2, he withdraws the \$100 deposit plus \$10 earned interest and uses it to buy consumption goods.

Qualified Accounts Treatment. If the savings account is a qualified account, the individual would reduce his tax base by \$100 in year 1 and raise it by \$110 when he withdraws his funds from the account in year 2. At an interest rate of 10 percent, the discounted present value in year 1 of his second-year tax base would be \$110/1.10, or \$100.

Tax Prepayment Approach. Now, suppose instead that the savings account is not a qualified account. In this case, the individual is not allowed a deduction for the deposit and is not taxed on interest earned or on funds withdrawn in year 2. The discounted present value of his tax base would be the same in this case as under the cash flow rules initially presented. The tax base in year 1 would be \$100 higher, and the discounted present value of the tax base in year 2 would be \$100 lower, than if a qualified account were used. In other words, allowing a deduction for purchases of assets and taxing withdrawals -- the qualified accounts treatment --is equivalent to allowing no deduction for the asset purchase and exempting all interest earnings from tax -- the "tax prepayment" approach.

The consequences to the government of the two ways of taxing the purchase of assets would also be the same in present value terms. If the individual bought the asset through a qualified account, the Government would collect revenue on a tax base of \$110 in year 2. If the interest were exempt from tax, and no deduction for the asset purchase allowed, the government would collect revenue on a tax base of \$100 in year 1. This revenue would grow to \$110 by year 2 at 10 percent interest. Ignoring possible variations in average tax rates, the government would be left with the same revenue at the end of year 2 in both cases.

The example above suggests that all assets may be treated according to the tax prepayment method for required consumer durables. Asset purchases would not be deducted from the tax base, and all earnings from assets and sales of assets would not be included in the tax base. Thus, for assets not purchased through qualified accounts, it would not be necessary to keep any records for tax purposes. The expected present value of the tax base would be the same for both methods of tax treatment of assets, although the timing of payments would be different. Both methods of tax treatment of assets are consistent with a cash flow approach to taxation.

It is worth repeating that allowing an alternative treatment of financial assets outside of qualified accounts, tax prepayment, is not essential to the integrity of the proposal, but it would provide convenience and some other advantages. In the cash flow proposal presented in this study, purchases of financial assets except for investments in a family business or closely held corporation, would be allowed to have tax-free returns if the investment were not deducted. Alternative rules are possible: (1) to require all asset purchases, except for consumer durables, to be made through qualified accounts; or (2) to continue to tax returns from assets purchased outside of qualified accounts (i.e., dividends, interest, rental income, capital gains) as they would be taxed under either a comprehensive income base (described in chapter 3) or under the current tax law. The current taxation of returns would strongly encourage, but not require, taxpayers to purchase income-earning assets through qualified accounts. Otherwise, the present value of tax liability would ordinarily be higher and recordkeeping and tax accounting more costly.

Treatment of Borrowing and Lending

The equivalence between the amount invested in an asset and the expected present value of returns also permits two alternative ways of treating loan transactions. Normally, under cash flow accounting, receipts from a loan would be handled through qualified accounts. An individual would be required to report the loan proceeds in his tax base in the initial year. (Of course, if he used the loan proceeds to purchase investment assets through a qualified account in the same tax year, there would be no net tax consequence.) Subsequent interest and principal payments would then be deductible from the tax base in the following years. If the individual sold assets that had been purchased through qualified accounts in an amount just sufficient to pay the loan interest and principal, the net tax consequence would, again, be zero. On the other hand, if the loan were taken outside a qualified account, proceeds of the loan would not be included in the tax base, and repayments of interest and principal would not be deductible. Note, again, that the present value of the tax liability would be the same in either case. The discounted value of future interest and principal payments on a loan would be equal to the current proceeds of the loan.

Advantages of Taxpayer Option Treatment of Asset Purchases and Borrowing

There are significant advantages to a flexible cash flow tax that allows a taxpayer to chose, subject to certain limits, whether or not to use qualified accounts to make financial transactions.

Averaging of Consumption. One advantage is the potential for evening out over time large outlays that are made irregularly, such as the purchase of a house or an automobile, or payment for college. According to the rules suggested above, cash outlays for consumer durables would not be deductible, so that borrowing via a qualified account would produce taxable receipts for which there would be no immediate offset. In buying a home, an individual probably would wish to borrow outside a qualified account. Otherwise he would pay tax on the entire mortgage in the year of the purchase. If the loan were not obtained through a qualified account, the proceeds of the loan would not be included in the tax base, but future principal and interest payments would not be deductible. Thus, tax liabilities from consumption of the good financed by such a loan would be spread out over the period of repayment, as the taxpayer used receipts from other sources, such as current wages, to pay the loan interest and principal.

The existence of alternative ways of treating financial assets and loans for tax purposes would give individuals considerable flexibility in the timing of their tax liabilities. This feature of the cash flow tax is desirable because it would minimize the need for special averaging provisions. Averaging is desirable because increasing marginal rates would be applied to increases in the tax base for any single year.

With increasing marginal rates, an individual with a tax base of $10,000 in year 1 and $30,000 in year 2 will pay higher taxes than an individual with a tax base of $20,000 in both years. Whether the tax base is comprehensive income or consumption, it is hard to see why the first individual should be considered to be in a better position to pay taxes than the other.

An example of the optional use of qualified accounts for the purpose of averaging consumption is the following: Suppose an individual purchased a $40,000 house, on which the bank made available a $30,000 mortgage. If the individual chose not to include the loan proceeds from the $30,000 mortgage in his tax base, he could not deduct mortgage payments in future years. In effect, the individual could pay the principal and interest on the mortgage every year out of current receipts from other sources. The receipts used for the annual mortgage payments would be included in the tax base. Thus, the tax base on the mortgage could be made to approximate the schedule of mortgage payments on the house.

This leaves the problem of the down payment. The $10,000 used for the down payment, if withdrawn from a qualified account, would be included in entirety in the tax base in the year the house was purchased. The individual, if he had foreseen buying a house, could have avoided this problem by saving outside the qualified account. The money devoted to acquiring these financial assets would have been included in the tax base every year but, the tax having been prepaid, the lump sum withdrawal would not be subject to tax. These savings could then be transferred to the purchase of equity in housing. The prepayment of taxes would continue to apply to the stream of consumption services from housing, as it did to the yield from financial assets.

In most other cases, individuals would probably want to save in qualified accounts for averaging purposes. Most people save during their most productive years, when income is highest. The savings are used to finance consumption after retirement. By saving in qualified accounts, an individual could reduce his tax liability in the years when his income is high relative to consumption, and raise it in the future when income is low. On the other hand, saving outside of qualified accounts might be an individual's best strategy when he anticipates large consumption expenditures such as a down payment for a house or college expenses. To the extent that the taxpayer remains in the same tax bracket for substantial variations in his tax base, the choice among types of accounts for reasons of averaging would be unnecessary.

Privacy. A second advantage of allowing optional treatment of asset purchases is that taxpayers would not be compelled to make all financial investments through a third-party broker. The existence of assets not monitored by third parties, or by the government, would allow a person to maintain the privacy of his accounts without changing the present value of his tax base.

Equality of Treatment Among Asset Types. A third advantage of allowing optional treatment for financial assets is that it would give investors in such assets the same opportunities available to investors in consumer durables. For both types of investments the initial and subsequent amounts would not be deductible and all returns, including sale of the asset, would not be subject to tax.

Lifetime Perspective of the Cash Flow Tax

At this point, it is worth emphasizing again the lifetime perspective of the cash flow tax system. The flexibility of asset treatment and the use of individual discretion over any 1 year's tax liability would allow both postponement and advancement of tax liabilities. By allowing individuals to avoid taxes totally in some years by judicious rearrangement of asset purchases, these provisions might appear to provide a tax loophole. However, this loophole is apparent only -- any reduction in tax base must be matched by a future tax base increase of equal present value. There could be no advantage to deferral if interest earnings were positive. Furthermore, because of progressive tax rates, it would be to the advantage of taxpayers to try to average their tax base over time. Thus, taxpayers would have an incentive to pay some tax every year, even though the means to postpone the tax is available.

An Example. To see how an individual could use the system to avoid taxes in a given year, and why it would not be to his advantage, consider this example. Suppose a worker earned $20,000 per year and accumulated wealth equal to $20,000 by saving outside a qualified account. In another year, he deposits the entire $20,000 in a qualified account, deducting the deposit from his wages. He would then report taxable receipts of zero in that year and, thereby, succeed in "sheltering" his consumption. (Less than $20,000 would need to be switched to a qualified account if there are personal exemptions.) However, this way of managing his financial portfolio probably would increase, rather than decrease, the present value of his tax payments over his lifetime.

This point can be illustrated by showing that taking part of the $20,000 deduction in either a previous or future year, would yield tax savings. For example, suppose he deposited only $19,000 in a qualified account in the year in question, deducting the additional $1,000 by depositing it in a qualified account on the first day of the following year. With increasing marginal tax rates, the increased tax liability from increasing the tax base from zero to $1,000 in the current year will be much smaller than the reduction in tax liability from the slightly greater than $1,000 reduction in tax base in the following year, when taxable consumption is much higher.

Alternatively, the individual might have taken a $1,000 deduction by depositing money in a qualified account in the last day of the previous year, leaving only $19,000 in assets outside qualified accounts in the year in question. Again, the increased tax liability from a $1,000 increase in tax base in the year in question would be smaller than the reduced tax liability from a $1,000 reduction in tax base through taking the deduction in the previous year, when taxable consumption is much greater than zero.

Thus, with increasing marginal rates, the taxpayer who uses the asset flexibility features of the model cash flow tax to acquire a year of tax-free consumption pays for that privilege. The present value of his tax liability would be increased in either prior or future years by an amount greater than the present value of tax saving in the "tax-free" year.

Uncertain Outcomes: A Problem with the Tax-Prepayment Approach

Tax Liability Can Be Independent of Outcome for Risky Investments. The major disadvantage of allowing a wide variety of financial assets to be purchased outside qualified accounts is that some large gains would go untaxed. When an asset has been purchased through a qualified account, the government could be viewed as participating in the investment, by allowing a tax deduction, and also participating in the return on the investment, by taxing the gross proceeds. For assets purchased outside of qualified accounts, however, the investment would not be deducted and the entire proceeds of the investment could be liquidated for consumption purposes tax-free.

If taxes were proportional, the after-tax rate of return would be the same in both cases. With qualified accounts, the Government in a sense would be a partner in the investment, sharing in the cost and appropriating a fraction of the return. When the tax is prepaid, however, the Government "share" in the returns would be zero. For assets bought outside of qualified accounts, large winners would not pay a higher tax and losers would not receive a loss offset. Although both types of tax treatment would allow investors equal opportunity to earn after-tax dollars, the tax treatment of assets purchased outside of qualified accounts would not distinguish between winners and losers of investment gambles. Thus, lucky investors might become very rich and owe no additional tax liability on future consumption of their wealth, if the initial investment were tax prepaid. Conversely, unlucky investors will have prepaid a tax on expected returns and will then obtain no deduction for the losses they incur.

A second potential problem with tax-prepayment of returns from assets would arise if tax rates were subsequently increased sharply -- for example, to finance a war. In that case, individuals who had prepaid tax on assets at the lower rates would escape taxation at the higher rates even if they were using the proceeds of profitable investments to finance current consumption. Of course, in making the tax-prepaid investments, those individuals ran the risk that tax rates might have been lowered, in which case they would have reduced their tax liability by buying assets through a qualified account.

It may be viewed as desirable in view of these problems to modify the current proposal by restricting, or even eliminating, the provision for purchase of income-earning assets outside of qualified accounts. One possible compromise would be to force all "speculative" investments, i.e., land, stocks, etc., to be purchased through qualified accounts but to allow the tax-prepayment option for fixed interest securities and savings deposits.

Consumer Durables. A similar problem would exist for consumer durables. Because consumer durables could not be purchased using qualified accounts, unanticipated increases in the value of consumer durables would be untaxed and there would be no tax offset for unanticipated losses. For example, if the value of an individual's house doubled in a year, his tax liability would not be affected. The option of requiring qualified-account treatment is not available here, as it is in the case of financial assets, because of the difficulty of measuring the value of the consumption services these assets provide.

No Optimal Treatment for Nonfinancial Business Assets

As explained above, investments in individual businesses would be eligible only for tax treatment on a current cash flow basis. All outlays for the business would be eligible for deduction, while all net receipts would be subject to tax. The reason for not allowing the alternative "tax-prepayment" treatment is that it is sometimes difficult to distinguish between the profits and wages of individual businessmen. If profit alone were exempted from tax, the businessman would have an incentive to avoid tax on the value of his labor services by paying himself a low wage and calling the difference return from investment. This problem would exist for individual proprietorships and possibly for small partnerships and closely held corporations. For such enterprises, all net receipts should be taxable and outlays for capital goods should be eligible for immediate deduction.

Table 1 below summarizes the proposed rules for tax treatment of financial assets, durable goods, loans, and family business enterprises. Note that the only restrictions are that all investments in a family business must be treated as if they were purchased in qualified accounts and consumer durable goods could not be purchased through qualified accounts. Financial assets could be purchased, and loans obtained, either through qualified accounts or outside of the system.

Table 1

Summary: Tax Treatment of Assets Under Cash Flow Tax

	Qualified Accounts	Accounts Outside of System
1. Financial Assets	purchases deductible; all withdrawals of earnings and principal taxed	purchases not deductible; interest and return of capital not taxed
2. Durable Goods	not available	purchases not deductible; sales not included in tax base
3. Loans	receipts in tax base; repayments deductible	receipts not in tax base; repayments not deductible
4. Family Business*	all outlays deductible, including capital outlays; all receipts taxed	not available

* Includes a limited class of small businesses owned and operated by the same person(s).

DIFFERENCES BETWEEN CASH FLOW AND COMPREHENSIVE INCOME TAXES: SPECIFIC PROVISIONS

Pension Plans and Social Security

Under the cash flow tax, all contributions to pension plans may be viewed as contributions to qualified accounts, whether by the employee or by the employer. By this logic, contributions would not be included in the tax base, while retirement benefits would be included in full. Similarly, all contributions for Social Security would be excluded from the tax base, while all Social Security retirement benefits would be taxable. There would be no need, under the cash flow tax, to compute the income on pension funds attributable to individual employees because the accumulation would not be subject to tax.

Life Insurance

Both term life insurance and whole life insurance would be treated differently under the cash flow tax than under the comprehensive income tax.

With term life insurance, there is no investment income and, thus, no expected change in net worth. Under the comprehensive income tax proposal, premiums for term life insurance, whether paid by the employer or the employee, would be included in the insured's tax base, while proceeds from term life insurance policies would be tax-exempt. The general principle of treatment of gifts under a cash flow, or consumption, base tax argues for a different treatment. Term life insurance may be viewed as a wealth transfer from the policyholder to the beneficiary. Purchase of a term life insurance policy lowers the lifetime consumption of the policyholder and raises the expected lifetime consumption of the beneficiary. Thus, a cash flow tax that taxes consumption of individuals should not tax premiums paid by the policyholder but should include proceeds from a term life insurance policy in the tax base of the beneficiary. In practice, this would mean that employer contributions to term life insurance would not be imputed to the tax base of the policyholder, while term life insurance premiums paid directly by the policyholder would be deductible.

Whole life insurance poses a different issue, although it would receive the same treatment as term insurance under the cash flow tax. A whole life insurance policy does provide investment income to the policyholder in the form of an option to continue to buy insurance at the premium level appropriate for the initial year. Under a cash flow tax, unlike the comprehensive income tax, the increase in the value of the option would not need to be computed for tax purposes because it would represent a change in net worth and not in consumption. However, if the individual cashed in the option value, the receipts from this transaction would be included in the cash flow tax base.

Under the model cash flow tax, all premiums paid by policyholders for whole life insurance would be tax deductible, while premiums paid by employers for policyholders would not be imputed to policyholders' tax bases. All receipts from life insurance policies, whether in the form of cash surrender value to policyholder or proceeds to beneficiaries, would be included in the tax base of the recipient.

State and Local Bond Interest

Under the model cash flow tax, State and local bond interest for securities not purchased through a qualified account would remain tax-exempt, as under the present law. However, as with the comprehensive income tax proposal, State and local bonds would lose their special status relative to other assets. Under the comprehensive income tax, these bonds would lose their special status because their interest would become taxable. Under the cash flow tax, the bonds would lose their special status because returns from all other assets would also become tax-exempt.

If State and local bonds were purchased through a qualified account, all contributions to the account would be deductible from the cash flow tax and all withdrawals from the account would be subject to tax. Thus, the purchase price of a State or local bond would be deductible, while withdrawals of interest payments and principal from the bond to pay for consumption would be subject to tax.

Interest Paid

Under the comprehensive income tax, all interest paid would be tax deductible because such outlays represent neither consumption nor additions to net worth. This would include interest payments for mortgages on owner-occupied homes. Under the cash flow tax, however, if a loan were taken through a qualified account, the initial proceeds of the loan would be taxable, while subsequent interest and principal repayments would be tax deductible. In present-value terms, the net effect of a loan on the tax base would be zero.

Corporate Income

Corporations would not be taxed as entities under either the cash flow tax or the comprehensive income tax. However, under the cash flow tax, there would be no need to impute undistributed income to individuals because taxes would be assessed only on funds available for personal consumption. Consequently, a single cash flow tax applied at the household level could be accomplished without the rules for integrating corporate and household accounts that are conspicuous features of the model income tax.

The treatment of returns from corporate activity under the cash flow tax would be exactly the same as the treatment of returns from other kinds of investments. There would be no separate tax at the corporation level. Individuals would be permitted to purchase corporate stock through qualified accounts held with brokers. The initial purchase price would be deductible from the tax base at the time of purchase, and subsequent withdrawals from the account as dividends received, return of capital, or proceeds from the sale of stock would be added alike to the tax base. For stock purchased outside of a qualified account, no deduction would be allowed for purchases, and neither dividends nor proceeds of future sales would be added to the tax base. Capital gains and capital losses would, therefore, have no tax consequences.

Capital Gains and Losses

Under the cash flow tax, there would be no need to keep records of the basis of asset purchases to compute capital gains. As explained above, when assets are purchased outside of qualified accounts, capital gains would be exempt from tax and capital losses would not be deductible. If assets are purchased within qualified accounts so that a deduction may be taken for the initial purchase price, no distinction would be made between the part of the sale that represented capital gain and the part of the sale that represented return of basis. In this latter case, the full amount of the sales proceeds, if not reinvested, becomes part of the tax base. The size of the capital gain would affect the amount of withdrawals for future consumption. Hence, when qualified accounts are used, the size of capital gains would have tax consequences even though no explicit calculation of gains (or losses) is necessary.

Because the cash flow tax does not tax accumulation, the issues of deferral, inflation adjustment, and the appropriate rate of tax on capital gains need not be considered, as they were in the discussion of a comprehensive income tax. The concept of deferral of tax would be relevant for the cash flow tax only if one could postpone without interest the tax liability associated with current consumption. Similarly, the value of assets or changes in the value of assets, whether related to general inflation or not, would not be relevant for the cash flow tax until they are withdrawn to finance consumption.

Business Income Accounting

Income accounting for any individual's business under the cash flow tax would be strictly on a cash accounting basis. The individual would have to compute in any year net receipts from operating the business. To perform this computation, he would add to the sale of goods and services during the accounting year any receipts from borrowing and would subtract the purchases of goods and services from other firms, wages paid to employees, interest paid to suppliers of debt finance, and all purchases of plant and equipment. Net receipts calculated by this method would be included in the individual's tax base, if positive, and would be deducted, if negative.

Note that the major difference between the cash flow tax and the comprehensive income tax with respect to business accounting is the treatment of assets. Under the cash flow tax, purchases of assets would entitle the businessman to an immediate deduction for the amount of purchase. Under the comprehensive income tax, deductions each year would be limited to a capital consumption allowance (depreciation), which estimates the loss in value during the year of those assets.

Also, business loans would be treated differently under the cash flow tax. All receipts of loans to a business would be included in the base, while interest and amortization payments would be deductible. Under the comprehensive income tax, loan receipts and amortization payments would have no tax consequences; only the interest payments would be deductible. When the proceeds of the loan are used immediately to purchase materials or services for the business, the deduction allowed under the cash flow tax just matches the addition of loan proceeds to the base.

For partnerships, the rules are simpler. A partnership would be required to report the annual cash contribution of each owner to the business and the annual distribution to each owner. The difference between distributions from partnerships and net contributions to partnerships would enter the individual owner's tax base. If the owner sold his shares, it would enter the tax base as a negative contribution.

SPECIAL PROBLEMS: PROGRESSIVITY, WEALTH DISTRIBUTION, AND WEALTH TAXES

The cash flow tax outlined in this proposal would tax consumption but not individual accumulation of assets. People are likely to conclude that such a tax would be regressive and that it would encourage excessive concentration of wealth and economic power. This section examines both these concerns, showing that concern about regressivity is a misconception and suggesting that the cash flow tax could be complemented in any desired degree by a transfer tax to influence wealth distribution. The complexities in the tax treatment of transfers at death caused by the existence of two kinds of financial assets are discussed below and some potential solutions are proposed.

Progressivity of the Tax

Exemption of Capital Earnings. The assertion that a consumption base tax is regressive stems from the fact that wealth is concentrated among relatively few households as compared to labor earnings. Because the cash flow tax is equivalent in present-value terms to exemption of earnings from capital, it would necessarily tax labor earnings more heavily to raise the same revenue. Thus, it might appear that the cash flow tax is a way of shifting the tax burden to the wage-earner class and relieving the wealthy taxpayer.

Such criticism of the cash flow tax may be superficially plausible but it is misleading on several grounds. First, much of what is generally labeled capital income is really a reward for postponing immediate consumption of past wages. Laborers as a class do not necessarily lose when the tax rate applied to wages immediately consumed is raised to enable forgiveness of taxes on the returns for saving out of wages. Second, the only other source of funds for investment aside from wages is transfers received (including inheritances), and these would be subject to tax at the same rate schedule applied to labor earnings under the cash flow tax. (This point is elaborated below.) Finally, the progressivity of any individual tax is to a large degree determined by the rate structure. The choice between a comprehensive income and a consumption base is independent of the degree of vertical progressivity of the rate structure.

Transfers of Wealth. The mechanism by which gifts and inheritances would be included in the tax base is simple. In order to be eligible for deduction by the donor, all gifts would have to be included in the tax base of the recipient. Gifts would be recorded only if they were transfers between taxable entities. Thus, a gift of a father to his 9-year-old son would not be included in the family's taxable receipts (unless it were removed from a qualified account). When the son left the family unit, say when he turned 26, he would become a separate taxpayer. At that point, all accumulated wealth from past gifts and inheritances would be included in his initial tax base and deducted from the family's base. If the initial base were large, the individual would have an incentive to purchase a qualified account to avoid a steep progressive tax, but would have to pay tax on subsequent withdrawals for consumption out of that account. Thus, an individual would not have the opportunity to realize tax-free consumption from a past inheritance.

Similarly, if the family's deduction for transfers to the son were large, the family would have an incentive to withdraw assets from a qualified account and treat such assets thereafter as held outside a qualified account. The family need suffer no adverse tax consequence, thereby.

The taxation of gifts and accessions to the donee and the deduction of itemized gifts by the donor are a logical, integral part of the cash flow tax system necessary to assure that the tax base is related to the lifetime consumption of every individual.

To see how inheritances would be included in the tax base of a cash flow tax, consider the following example. Suppose a man died on January 2, 1977 at the age of 70, leaving $300,000 in qualified accounts to his 35-year-old son. The tax base of the decedent in 1977 included a $300,000 withdrawal from the qualified account in receipts and a $300,000 deduction for the bequest of funds, for a net tax base of zero. The tax base of the son included the receipt of $300,000. With progressive rates, it is likely that the son would wish to deposit a large part of the $300,000 in a qualified account, paying tax only as the money was withdrawn for consumption.

A difficulty would arise if the $300,000 of the decedent, or a fraction thereof, were held outside a qualified account. While the tax treatment of the recipient's inheritance would be the same ($300,000 of receipts), the estate of the decedent has a large deduction, possibly with no current tax base to offset. The estate might then be entitled to a tax refund before the estate were divided up. This treatment would be appropriate because the decedent had, in effect, prepaid tax for consumption of the proceeds of the investment that was never consumed in his lifetime. However, an amount, or rate, of refund must be specified. One possibility would be to allow a refund to the estate equal to the value of investment assets outside of qualified accounts multiplied by the rate applicable to the lowest tax bracket. An alternative solution would be to give no refund at all. The inability to consume expected proceeds of a tax-prepaid investment because of death may be viewed as one of the risks an individual knowingly undertakes when he invests in a tax-prepaid asset. This treatment would also provide further incentive for investments to be made through qualified accounts.

If initial financial endowments and receipts of transfers are included in the tax base, there would be no difference in tax treatment between an individual who invests an inheritance and one who invests his savings out of wages. Neither would have any additional tax until he consumes the amount invested or the earnings. In effect, earnings from investment could be viewed as a reward for deferring consumption from wage income or inheritance. If the rate structure were appropriately progressive, so that the high-wage earners with large accessions would be paying a significantly higher tax than low-wage earners with small accessions, there would seem to be no particular reason to discriminate in tax liability between persons with different patterns of lifetime consumption. Viewed in that manner, the cash flow tax would not favor the wealthy but would favor, relative to a comprehensive income tax, those individuals who, *at any given income level*, chose to postpone consumption.

Lucky Gambles. Another potential objection to the proposed system on progressivity grounds is the opportunity it would afford individuals to acquire wealth by a lucky investment gamble, and to have paid only a small tax on the amount wagered. Some regard this possibility as inequitable. As noted above, this possibility could be largely avoided, at a price in complexity and compliance costs, by taxing the future returns on some or all investments that are not made through qualified accounts, or by restricting the types of investment that could be made outside of qualified accounts.

Accumulation of Wealth. The second major concern about a cash flow tax is that it would place no restraint on the accumulation of wealth. Although all consumption out of accumulated wealth would be taxed, the cash flow tax, compared with an income tax, would make it easier for individuals to accumulate wealth. The effect of this on the distribution of wealth in the United States cannot be forecast precisely. Presumably, individuals at all levels would tend to hold more wealth, so that the dispersion of wealth might either increase or decrease. At the same time, there might be an increase in the size of the largest wealth holdings.

The cash flow tax -- with wealth transfers deductible to the donor and included in the tax base of the recipient -- would be a tax on the standard of living of individuals (with some exemption, or credit, for a small consumption amount). Like the model comprehensive income tax, it could be converted to the concept of "ability-to-pay" discussed in chapter 2. According to that concept, wealth transfers would be regarded as consumption by the donor and included in the tax base of both donor and recipient. To accomplish this conversion, gifts would not be deductible to the donor and bequests would be taxed as a use of lifetime receipts.

A simpler approach, and one that is more consistent with present policies, would be to retain the estate and gift tax as the principal instrument for altering the distribution of wealth. Such a tax, which is levied according to the situation of the donor, would be a logical complement to the model cash flow tax. The existence of a separate estate and gift tax would not damage either the basic simplicity inherent in the treatment of assets under the cash flow tax or the neutrality in tax treatment of those individuals with the same endowment who have different time patterns of labor earnings or consumption. Under this option, all features of the cash flow tax would remain exactly as explained above, except for the wealth transfer tax. Tax rates on gifts and bequests could be designed to achieve any desired degree of equalization in initial wealth of individuals.

INFORMATION ON SAMPLE TAX FORM FOR CASH FLOW TAX

Filing Status

1. Check applicable status

   a. Single

   b. Married filing joint return

   c. Unmarried head of household

   d. Married filing separately

Exemptions

2. If applicable, enter 1 on line

   a. Regular

   b. Spouse

3. Number of dependent children

4. Total exemptions (add lines 2a, 2b, 3)

Receipts

5a. 1/ Wages, salaries, and tips of primary wage earner (attach forms W-2)

 b. Wages, salaries, and tips of all other wage earners (attach forms W-2)

 c. Multiply line 8b by .25; if greater than $2,500, enter $2,500

 d. Included wages of secondary worker (subtract line 5c from 5b)

 e. Wages subject to tax

6. Gross business receipts (from schedule C)

7. Gross distributions from partnerships (from schedule E)

8. Distributions from pension funds and trusts (includes social security benefits)

9. Gifts and inheritances received

10. Withdrawals from qualified accounts (if positive)

11. Disability pay, unemployment compensation, workmen's compensation, sick pay, public assistance, food stamp subsidy, fellowships, and other cash stipends

12. Alimony received

13. Total receipts (add lines 5c, and 6 through 12)

Deductions

14. Gross business expenses (schedule C)

15. Contributions to partnerships (schedule E)

16. Contributions to trusts

17. Deposits in qualified accounts (form S-2)

18. Other deductions (schedule A)

19. Total deductions (add lines 14 through 18)

Computation of Tax

20. Cash flow subject to tax (subtract line 19 from line 13)

21. Basic exemption (enter $1,500)

22. Family size allowance (multiply line 4 by $800)

23. Total exemption (add lines 21 and 22)

24. Taxable cash flow (subtract line 23 from line 20)

25. Tax liability (from appropriate table)

26. a. Total Federal cash flow tax withheld

    b. Estimated tax payments

    c. Total tax prepayments (add lines 27a and 27b)

27. If line 26 is greater than line 27c, enter BALANCE DUE

28. If line 27c is greater than line 26, enter REFUND DUE

Schedule A -- Deductions

Taxes

1. State and local income taxes

Gifts, Charitable Contributions, and Alimony

2. Gifts or donations to an identified taxpayer or entity (itemize)

3. Alimony paid

Cost of Earning Income

4. Union dues

5. Child care expenses (only for secondary workers or single adult households)

6. Multiply line 5 by one-half

7a. Enter line 6 or $5,000, whichever is smaller

b. Enter line 7a or line 4b (line 4a for unmarried head of household) from form 1040, whichever is smaller

8. Other costs (itemize)

9. Add lines 4, 7b, and 8

10. Subtract $300 from line 9

11. If line 10 positive, enter line 10; if line 10 negative enter 0

12. Add lines 1, 3, and 11; enter on form 1040, line 18

Schedule C (Business Receipts and Expenses)

Like current schedule C except

Line 5 total outlays for purchases of assets

Enter line 5 (total income) on form 1040, line 6

Enter line 20 (total deductions) on form 1040, line 14

Schedule E -- Note: Partnership will have to send information on form 1065 of gross distributions and gross contributions

Form S-2's -- Supplied by brokers of qualified accounts

1. Total deposits

2. Total Withdrawals

3. Net Withdrawal (line 2 minus line 1), if positive

4. Net Deposit (line 1 minus line 2), if positive

1/ Wages reported by the employer would exclude employee contributions to pension plans, disability insurance, health insurance and life insurance plans. Wages would also exclude the employee's share of payroll taxes for Social Security (OASDHI), and the cash value of consumption goods and services provided to the employee below cost.